

Czech Republic: 20 Years of Inflation Targeting and the Way Forward

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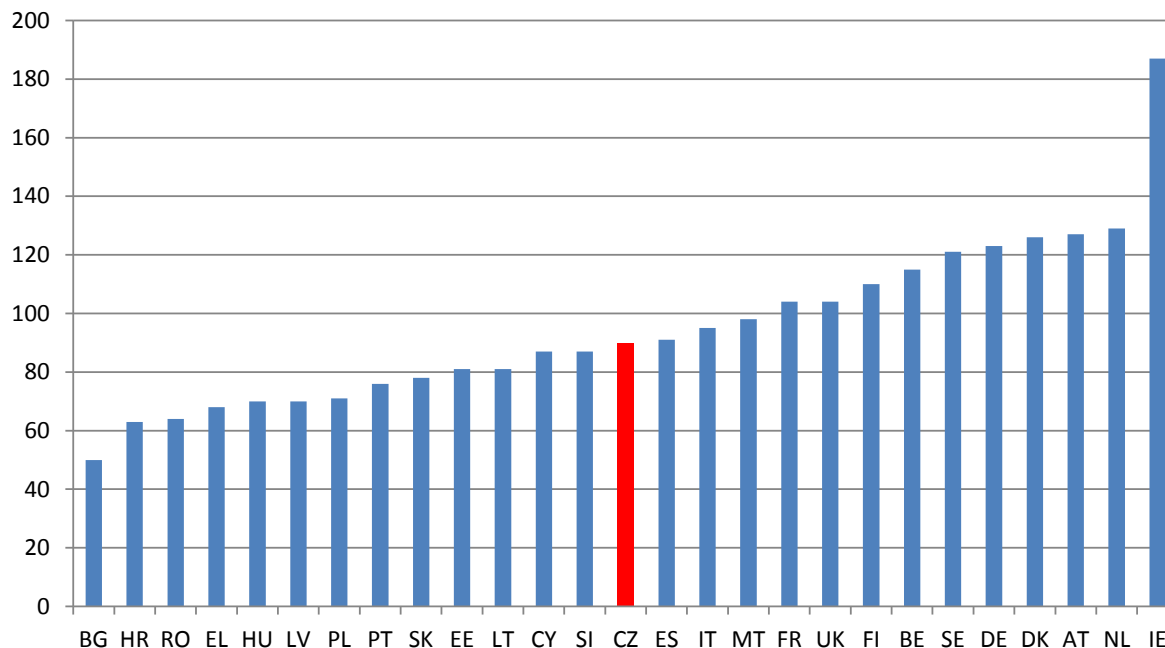
Central Bank of Malta

Valletta, 12 November 2019

- I. Economic situation in the Czech Republic
- II. 20 years of inflation targeting
- III. The way forward and the question of euro adoption

I. Economic situation in the Czech Republic

GDP per capita in PPP (2018; EU-28=100)

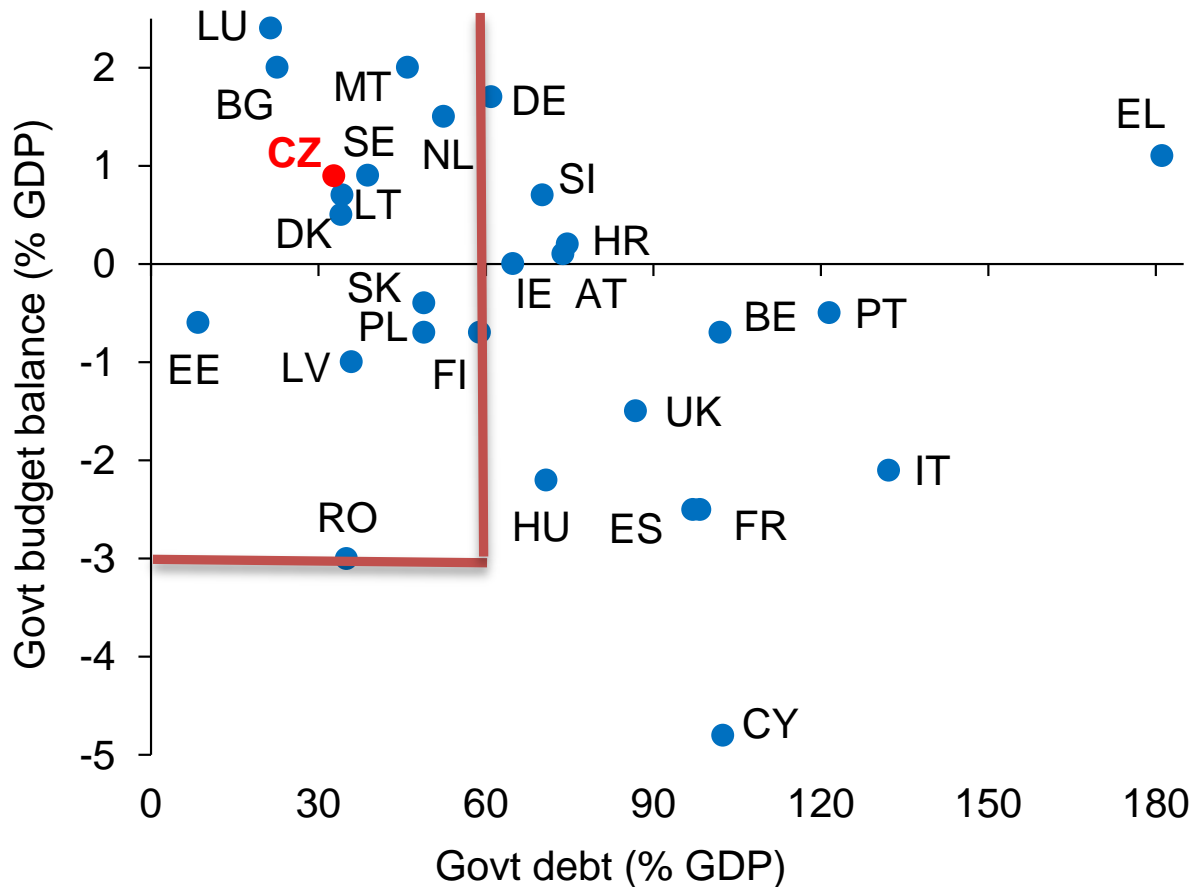


Note: Luxembourg not shown (254).

Source: Eurostat.

- In 1993–2018, cumulative real GDP growth was 94%, or 2.7% p.a.
- In 2018, GDP per capita at purchasing power parity reached 90% of the EU-28 average
- Second biggest car producer per capita in world (behind Slovakia)

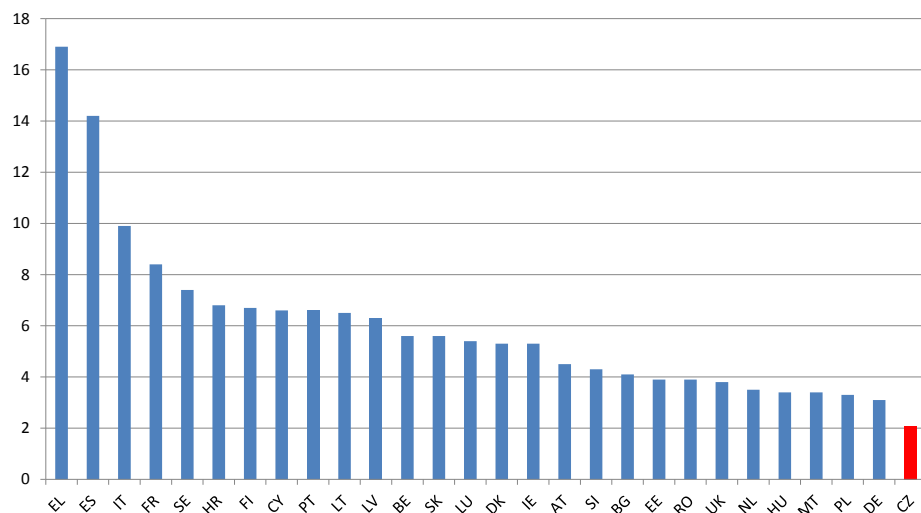
Fiscal positions of EU-28 countries



Source: Eurostat (September 2019).

- Public debt level was 32.7% of GDP in 2018

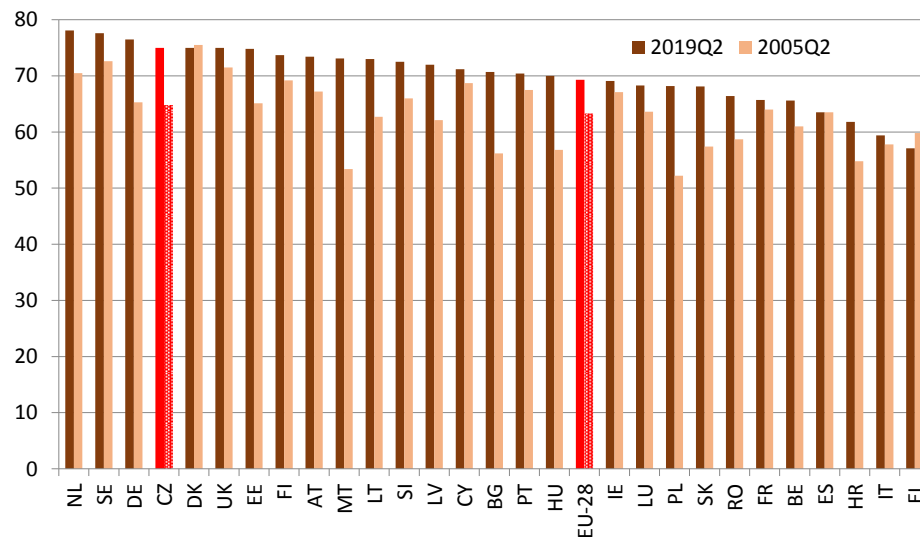
Unemployment rate (% , Sept. 2019)



Note: Seasonally adjusted data. August 2019 for EE, HU. July 2019 for EL, UK.

Source: Eurostat

Employment rate (%)

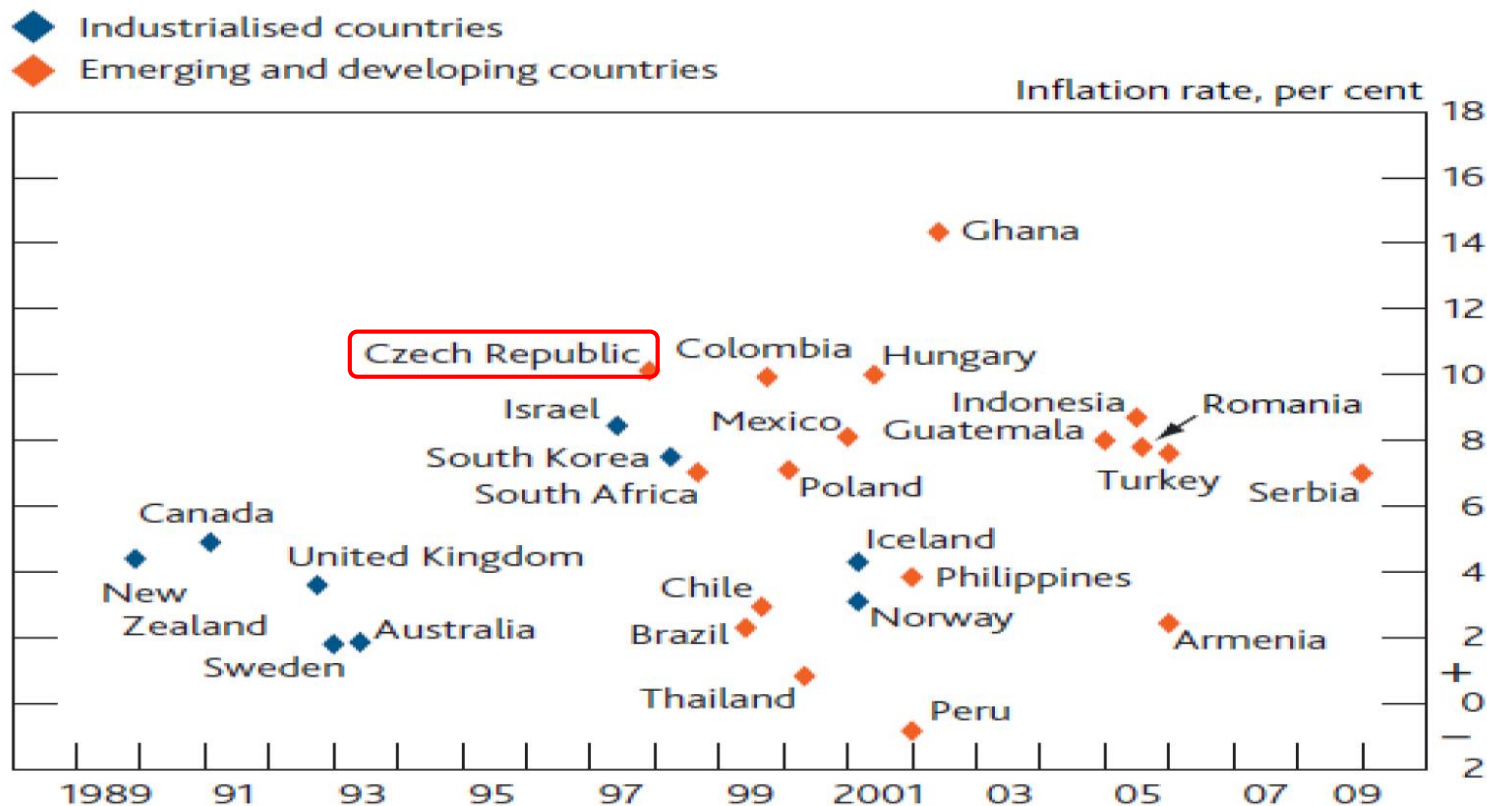


Source: Eurostat

- Unemployment rate is the lowest in EU (2.1% in September 2019)
- Employment rate has increased since 2005
- Among EU countries with the highest levels of social cohesion

II. 20 years of inflation targeting

20 years of inflation targeting (1)

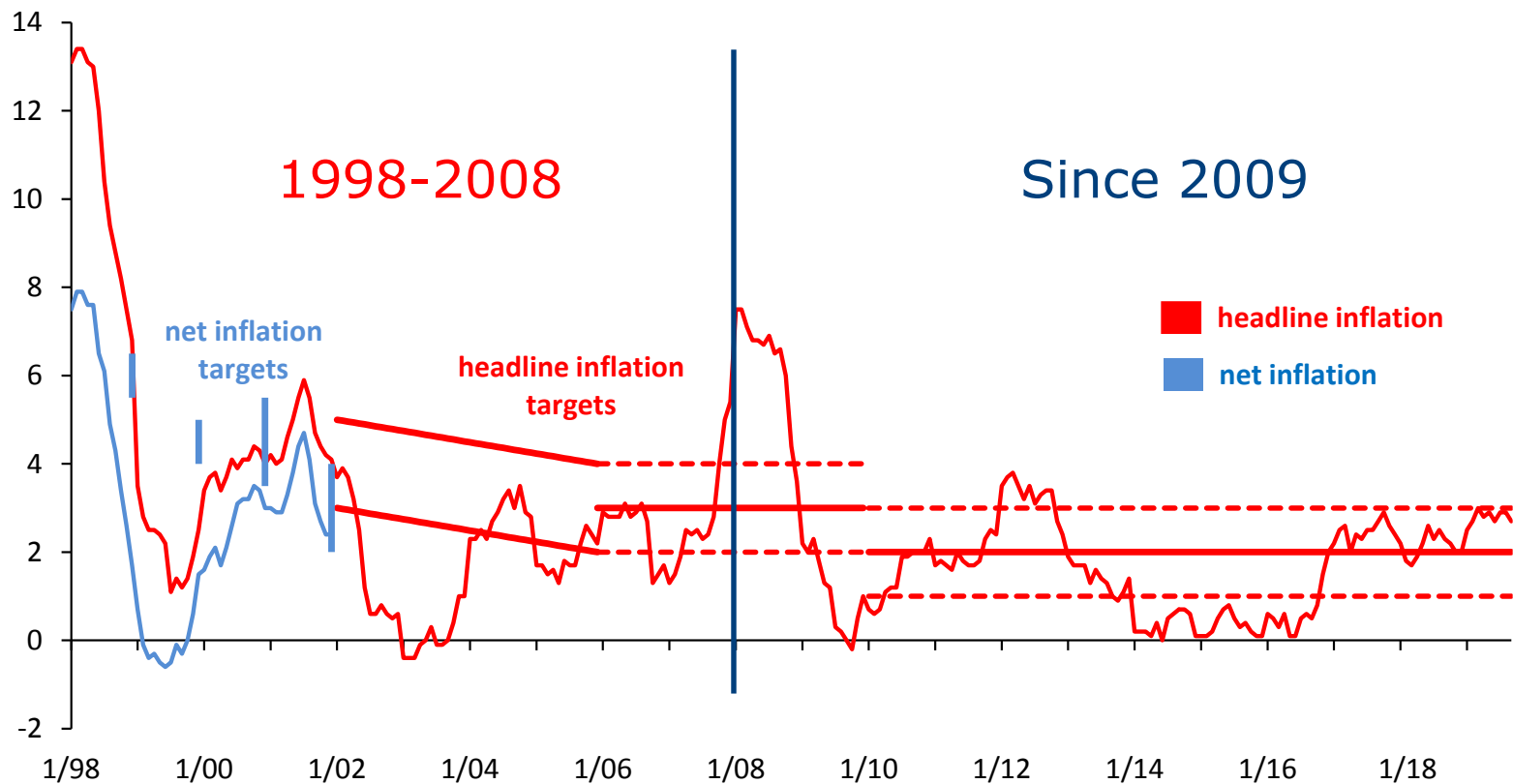


Source: Hammond (2012)

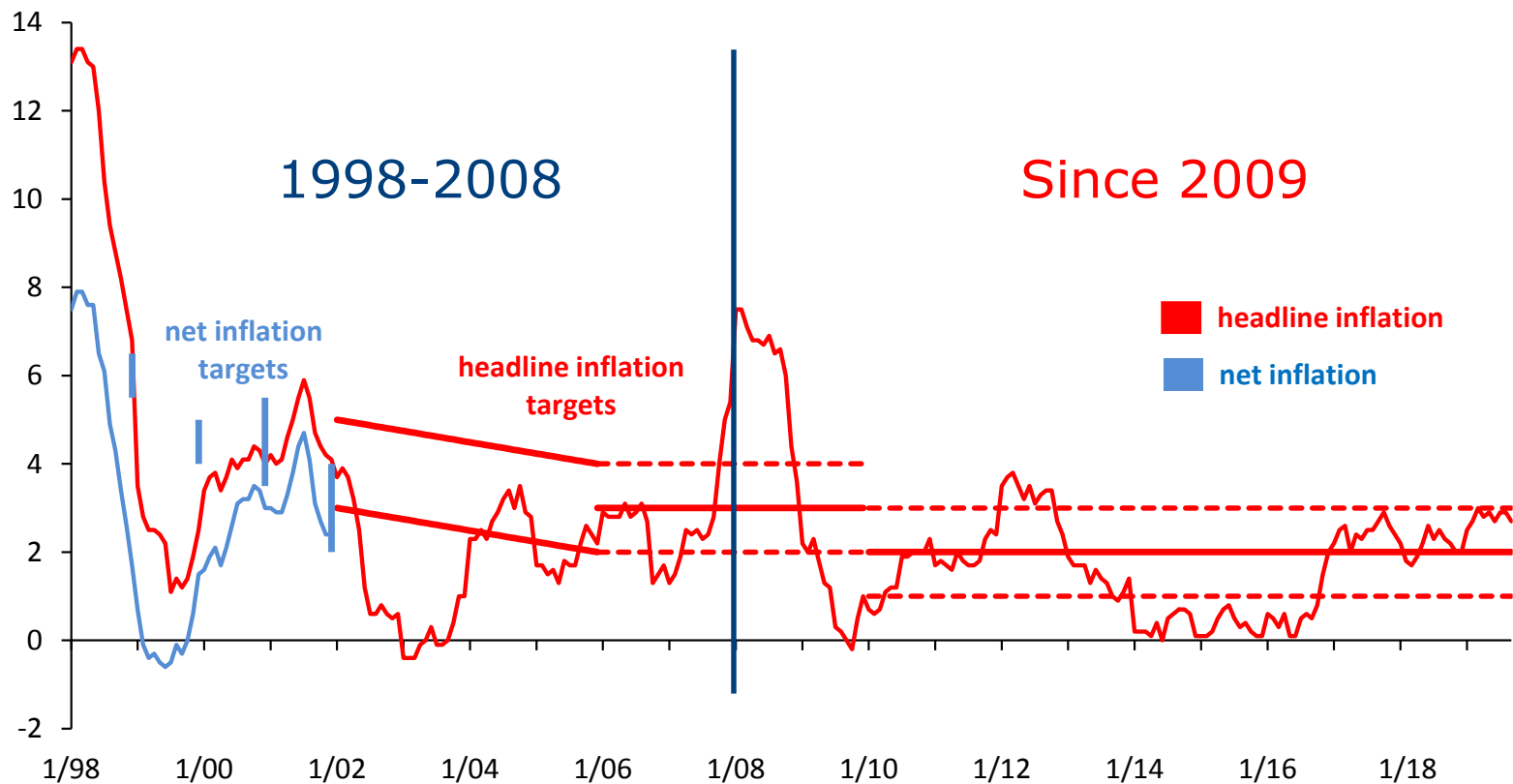
- Czech Republic was the first emerging economy to introduce inflation targeting in 1998 with the aim to achieve low inflation

- First decade (1998-2008): disinflation and inflation stabilisation
- Second decade (since 2009): effects of the financial crisis – unconventional monetary policy and back to normal

First decade (1998-2008): disinflation and inflation stabilisation

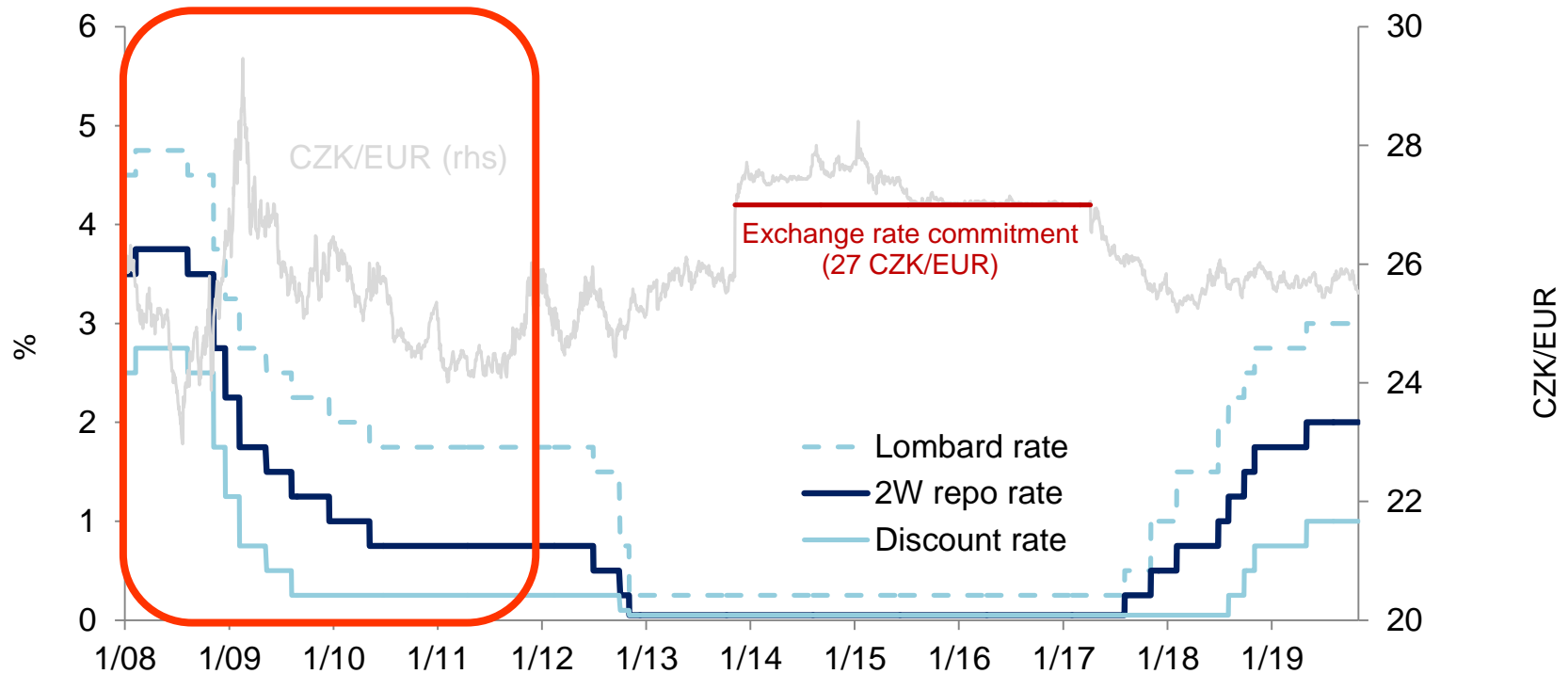


- Inflation rapidly reduced to values observed in developed countries
- However, there were significant temporary deviations from the target due to several (mainly external) shocks



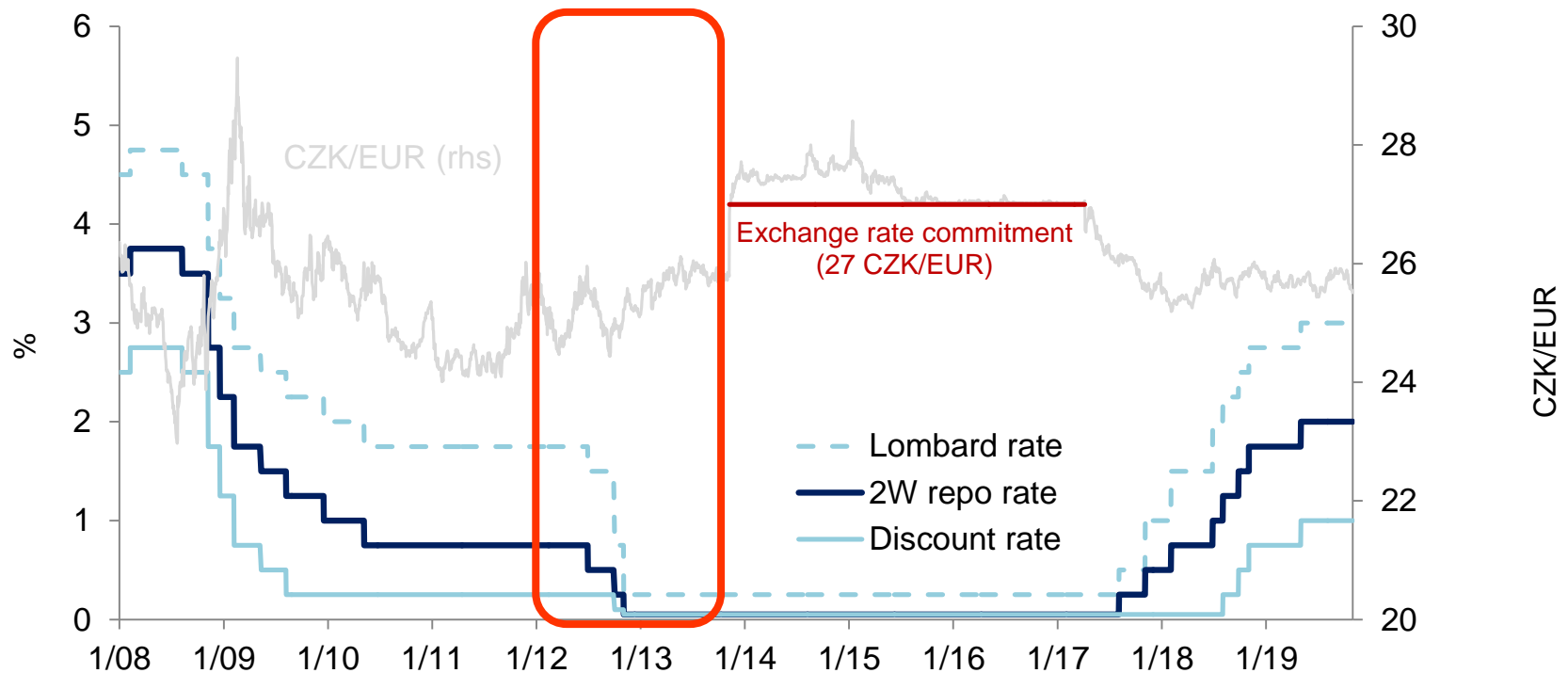
- Lowering the inflation target as of 2010 by 1 percentage point (to 2% with a tolerance band of +/- 1 p.p.)

Monetary policy reaction to the global financial crisis



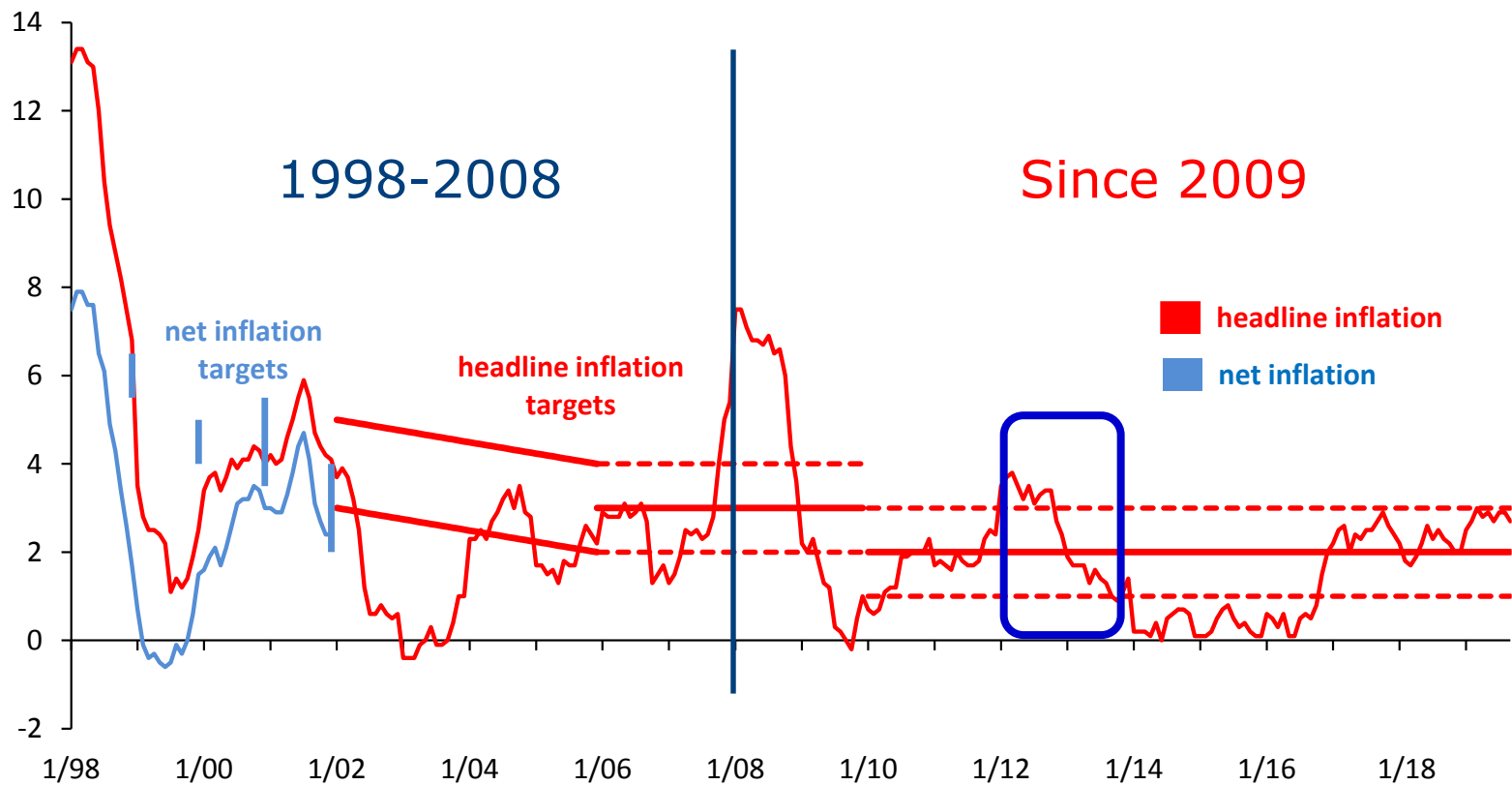
- Lowering of interest rates starting in summer 2008

Monetary policy reaction to the euro area debt crisis (1)

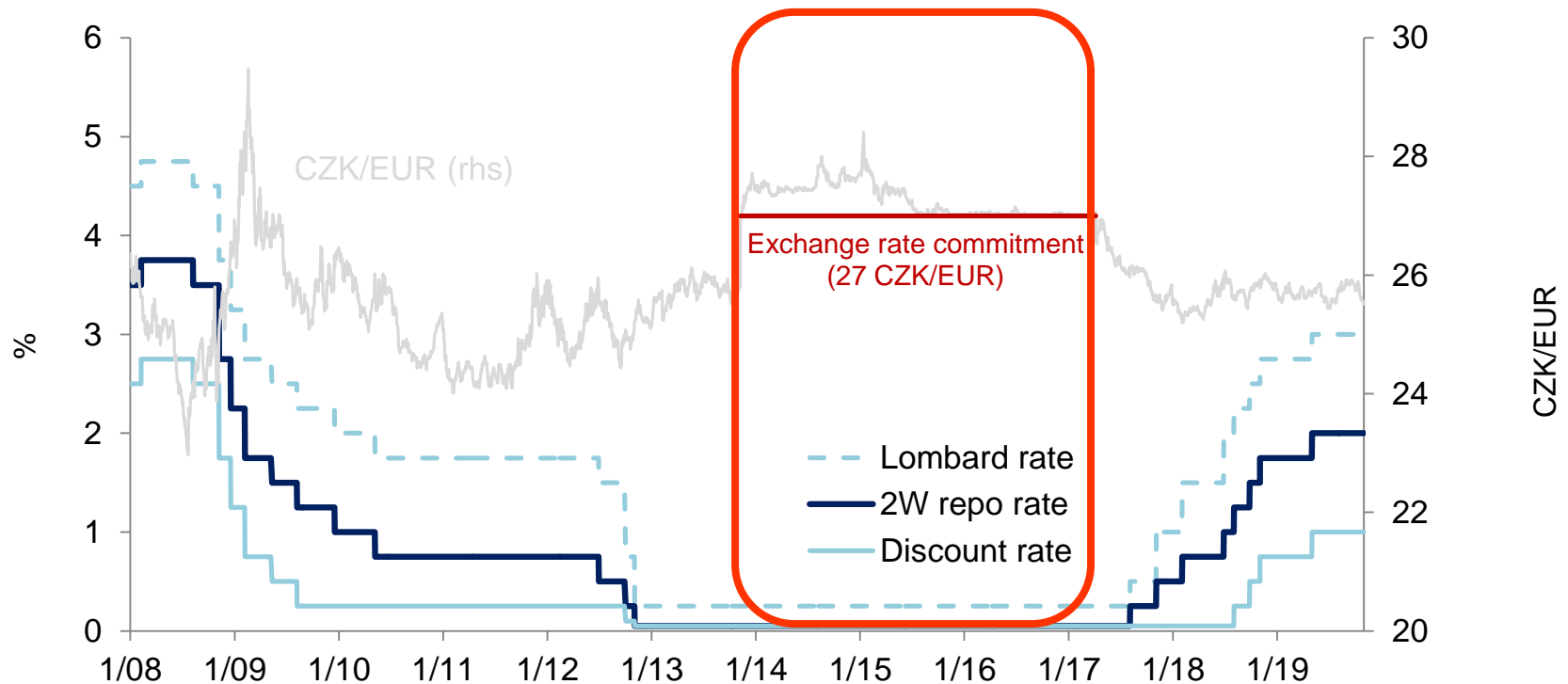


- Due to renewed lengthy recession, rates started approaching zero lower bound in 2012

Monetary policy reaction to the euro area debt crisis (2)

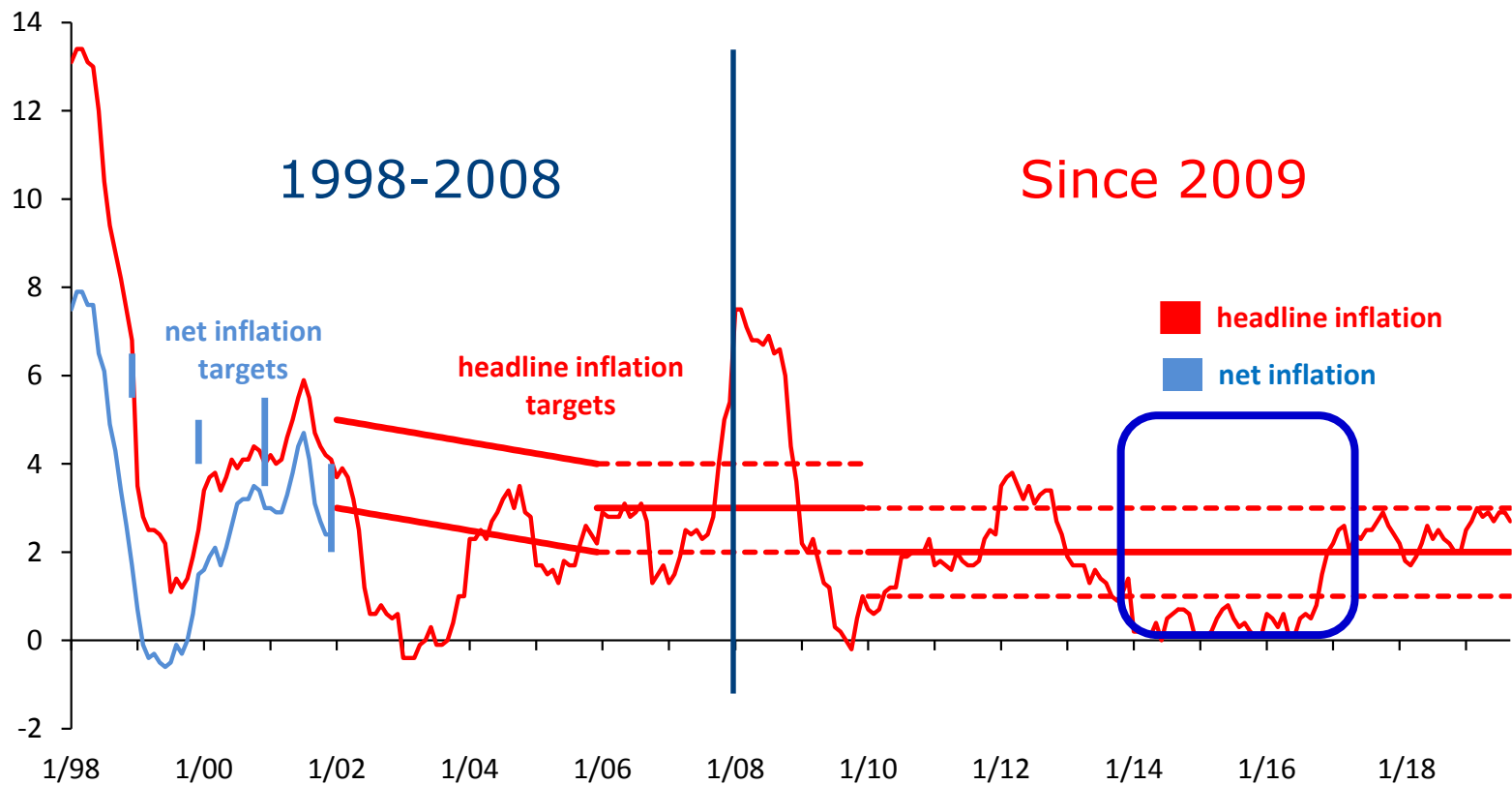


Exchange rate floor as a monetary policy instrument (1)

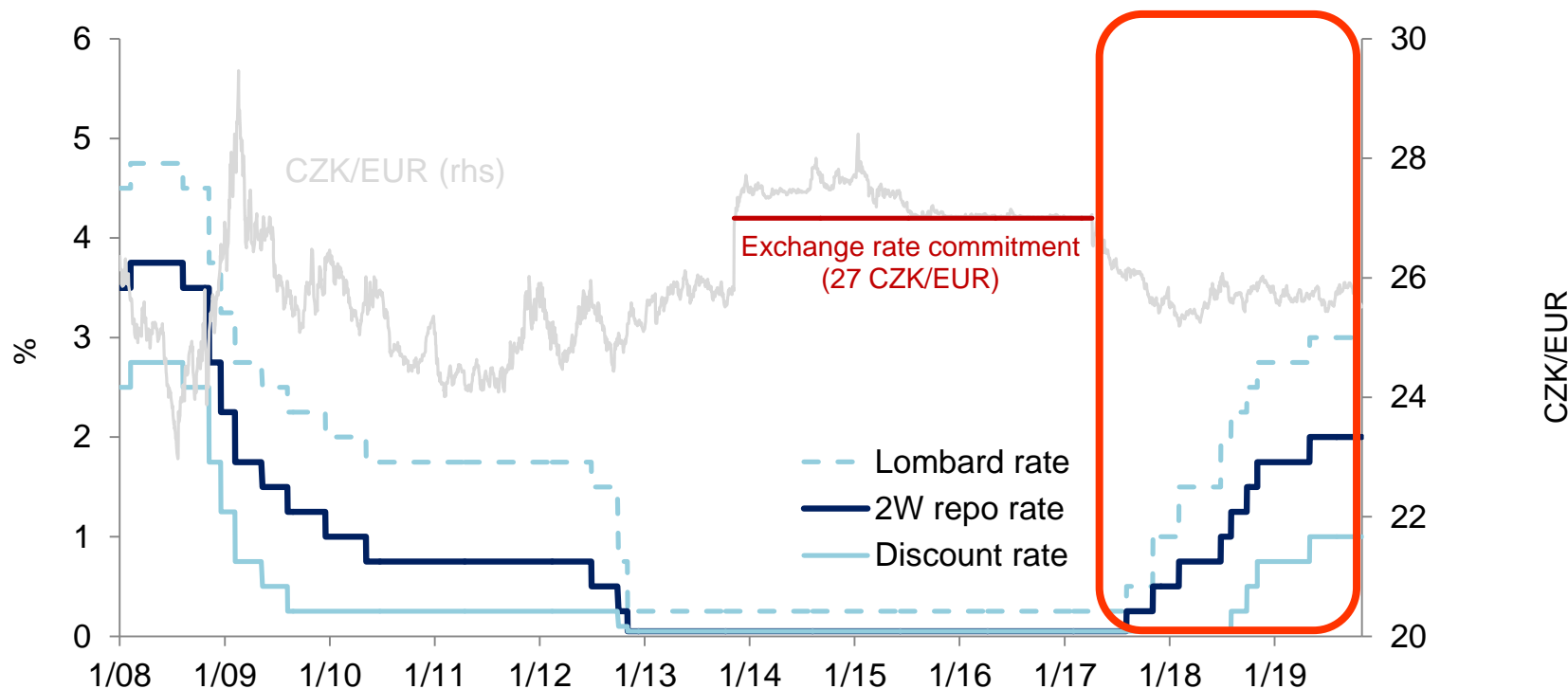


- Introduction of exchange rate floor at 27 CZK/EUR in November 2013

Exchange rate floor as a monetary policy instrument (2)



Normalisation of monetary policy since April 2017



- FX floor was abandoned on 6 April 2017, as conditions for sustainable fulfilment of 2% inflation target had been met
- Exit was smooth and was followed by eight interest rate hikes between 8/2017 and 5/2019. Czech koruna appreciated gradually and moderately

- The successful conduct of monetary policy under inflation targeting brought inflation down from high values to the level usual in advanced countries
- Subsequently, this regime was able to cope with the threat of harmful deflation during a lengthy domestic recession thanks to the use of the exchange rate as an additional monetary policy instrument
- Czech Republic has successfully moved towards normalization of monetary policy

III. The way forward and the question of euro adoption

Pros (benefits)

- Zero exchange rate risk with the main trading partners
- Lower transaction costs (no need for exchange)
- Higher price transparency and more competition
- Deeper economic integration (?)

Cons (costs)

- Loss of an important macroeconomic adjustment variable
- Higher degree of economic sovereignty (?)

The higher the cyclical and structural alignment with the euro area and the more flexible the economy, the more the benefits should be higher than the costs

- High degree of openness of the Czech economy
 - Persisting strong trade and ownership links
 - Gradually rising use of the euro by non-financial corporations
 - Signs of increasing labour market flexibility
 - Stable banking sector resilient to economic shocks
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- Still unfinished process of real economic convergence
 - Persisting lower structural similarity of economies
 - Misalignment of financial cycles
 - Czech public finance sustainability yet to be resolved

- Regardless the costs and benefits, the Czech Republic is obliged to adopt the euro since the EU entry
- Czech economy would manage to join the euro area as it converges to the euro area core as well as to the EU average
- Euro area faces many problems: some (big) economies do not converge; still incomplete and with many question marks
- Our obligation to adopt the euro is debatable because of new elements/duties linked to this obligation (e.g. additional costs related to joining the ESM)
- Euro adoption is not on the agenda in the near future

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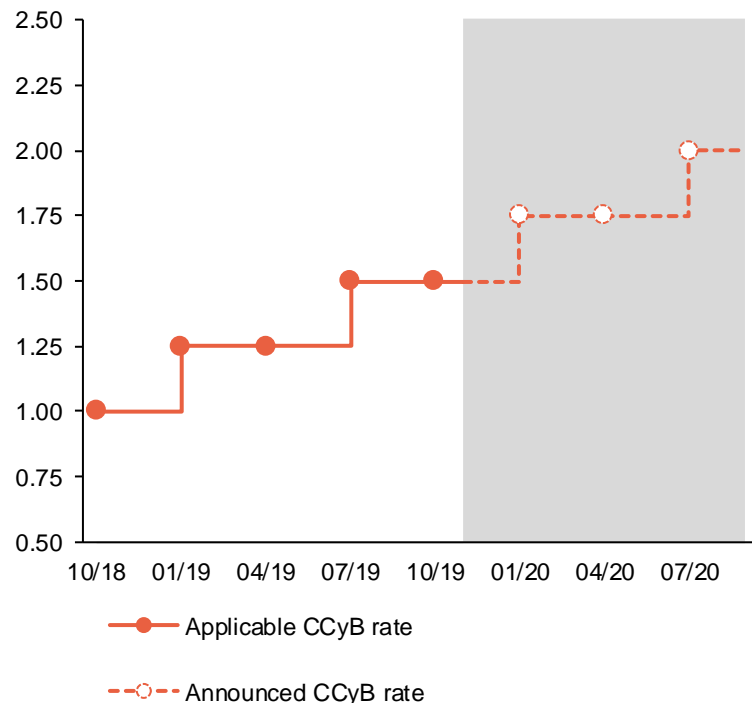
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Additional slides

- Monetary policy to maintain price stability (flexible inflation targeting)
- Issuing banknotes and coins
- Payment and currency in circulation management
- Financial stability
- Financial market supervision
- Resolution
- Consumer protection

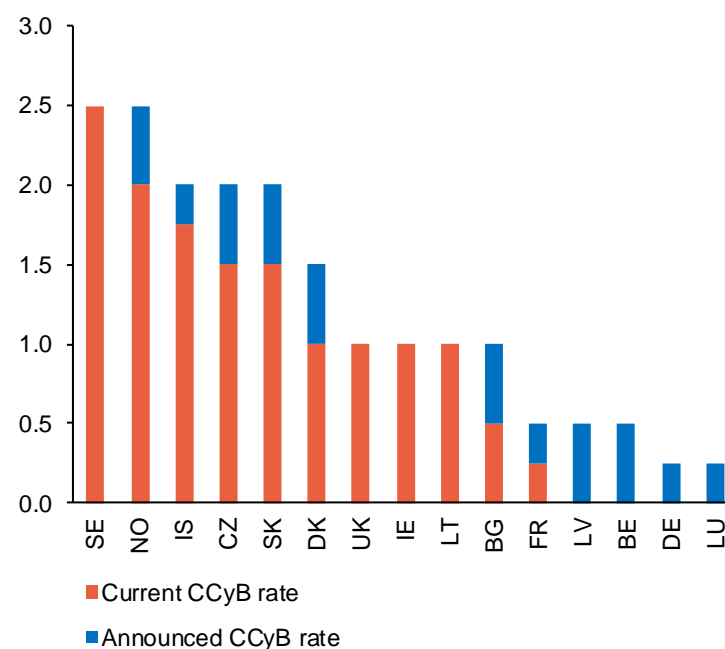
Setting of countercyclical capital buffer rate

Applicable and announced CCyB rate in the Czech Republic
(% of total risk exposure)



Source: CNB

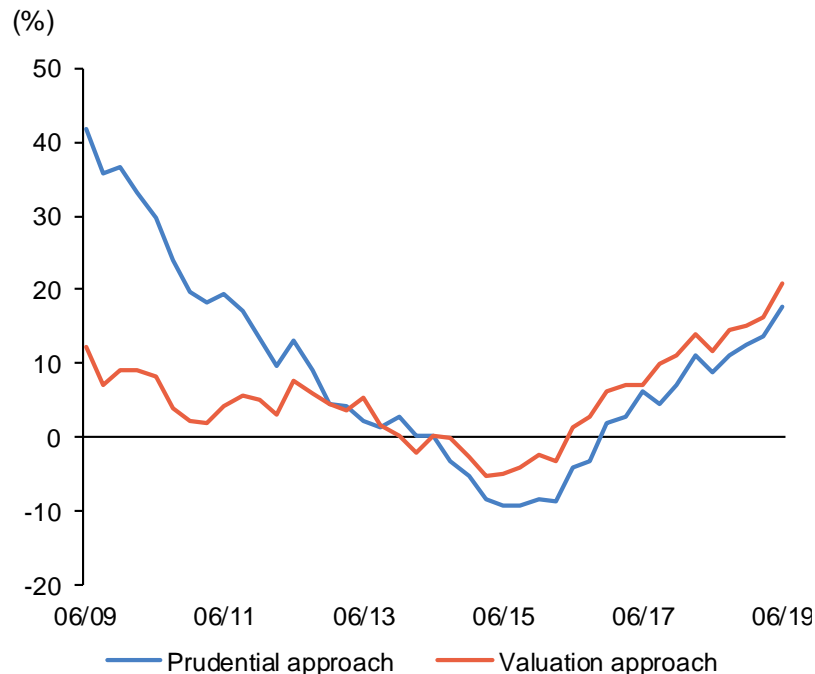
Countries with non-zero CCyB rate
(% of total risk exposure)



Source: ESRB

- Rise in CCyB rate to 2.0 % with effect from July 2020 is based on assessment of position of economy in financial cycle and of banking sector vulnerability indicators
- Fifteen European countries have set non-zero CCyB rates; in eleven non-zero rate already effective. Eleven have announced rate increase (including CZ)

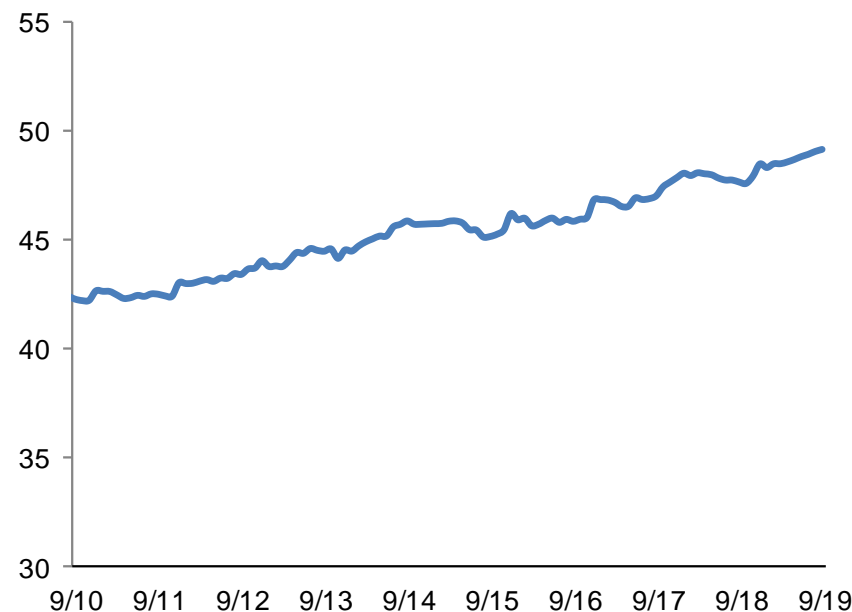
Estimated overvaluation of apartment prices



Source: CNB

Note: The methodology of the indicators is described in detail in Plašil, M., Andrlé, M. (2019): *Assessing House Price Sustainability*, Thematic Article on Financial Stability 1/2019, CNB.

Loans for house purchase in % of total private non-financial loans



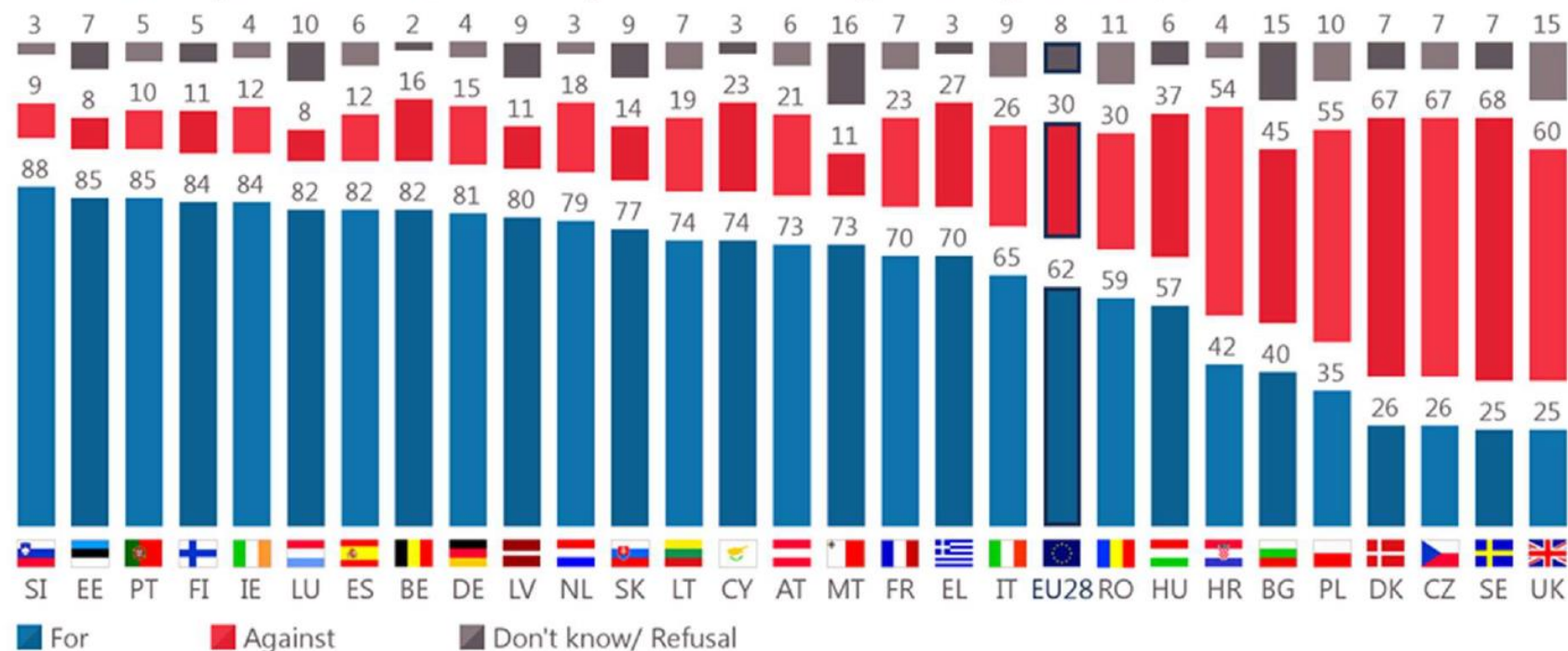
Source: CNB

- Upper LTV limit of 80%; max. 15% of loans for LTV of 80%–90%; no loans for LTV above 90%
- Upper DTI limit of 9 times applicant's net annual income and DSTI limit of 45% of applicant's net regular income
- Cap on maturity of 30 years, requirement of regular amortization

Public support to the euro

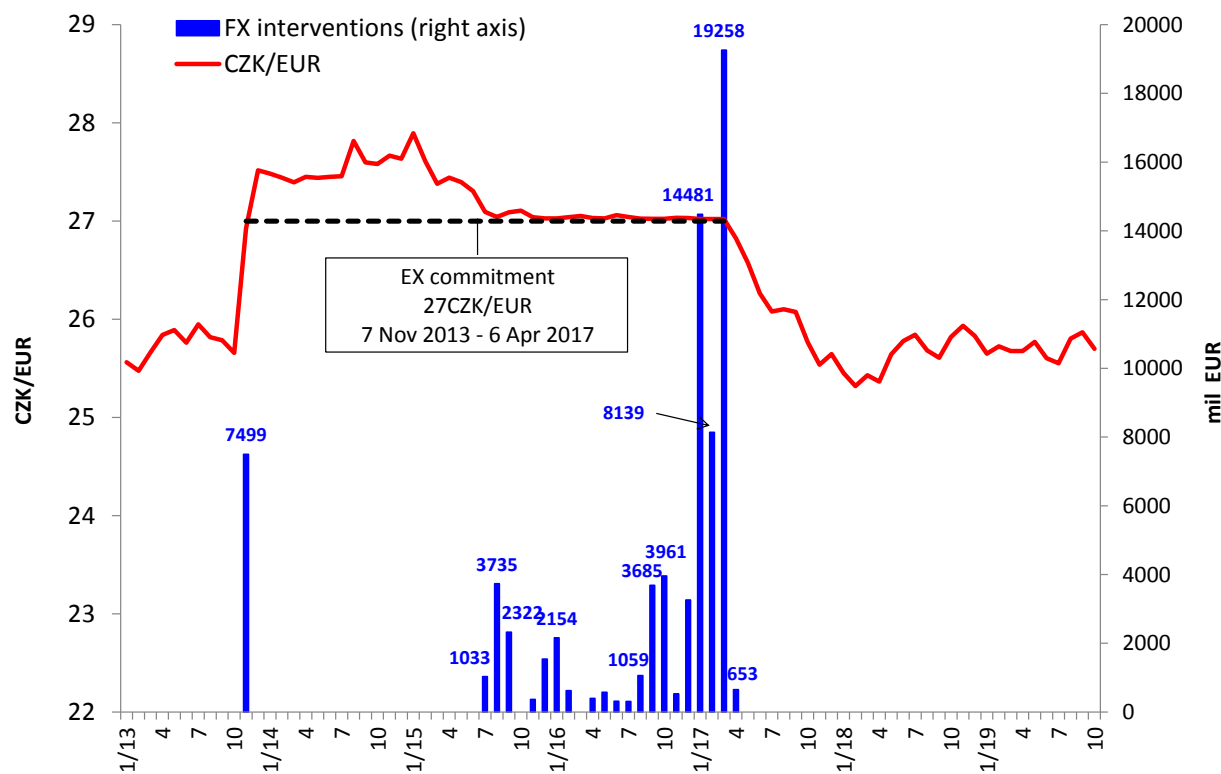
QA16.1 What is your opinion on each of the following statements? Please tell me for each statement, whether you are for it or against it.

A European economic and monetary union with one single currency, the euro (%)



Source: Eurobarometer, Spring 2019

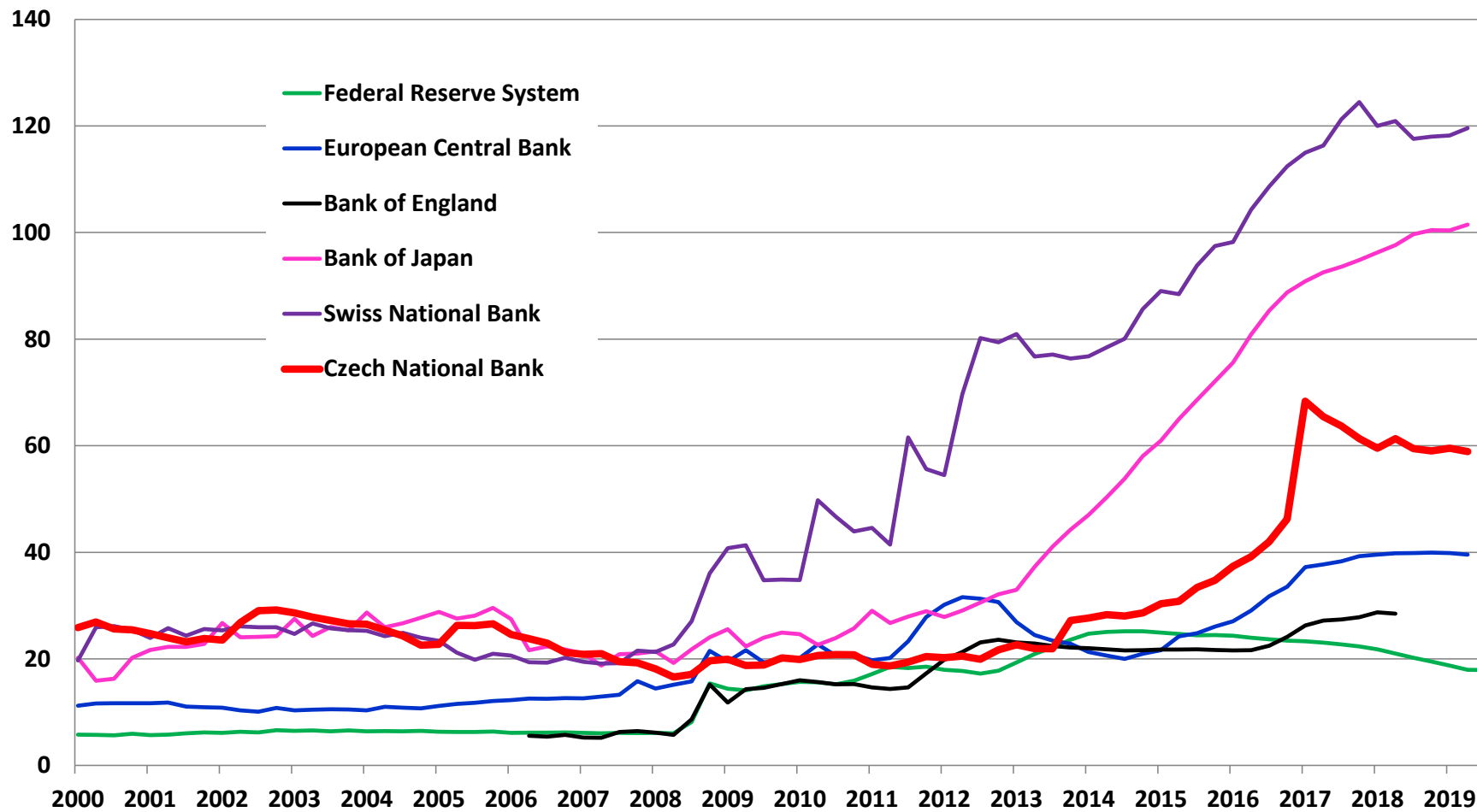
CZK/EUR exchange rate and FX interventions

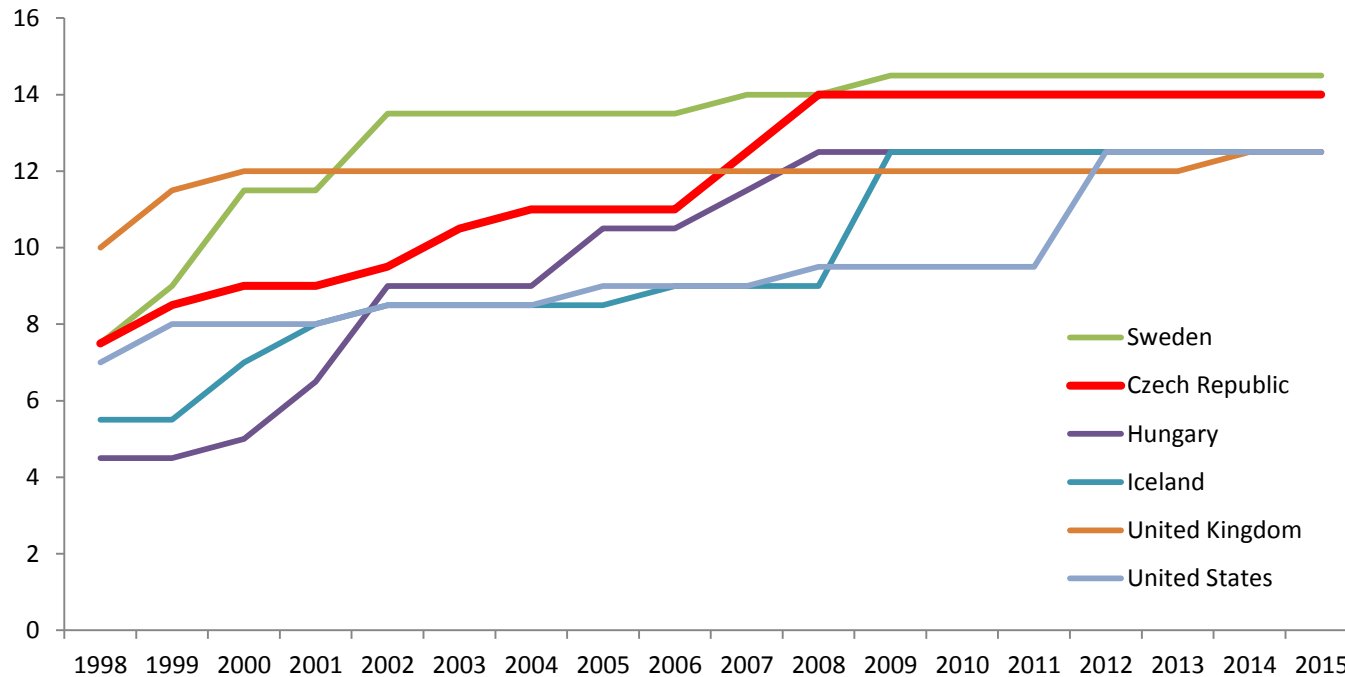


Source: CNB

- FX interventions amounted to 75.9 bil. EUR during the exchange rate commitment period from 7 Nov. 2013 to 6 April 2017 (of which 42.5 bil. EUR in 2017)

Central bank total assets to nominal GDP in national currency (in %)



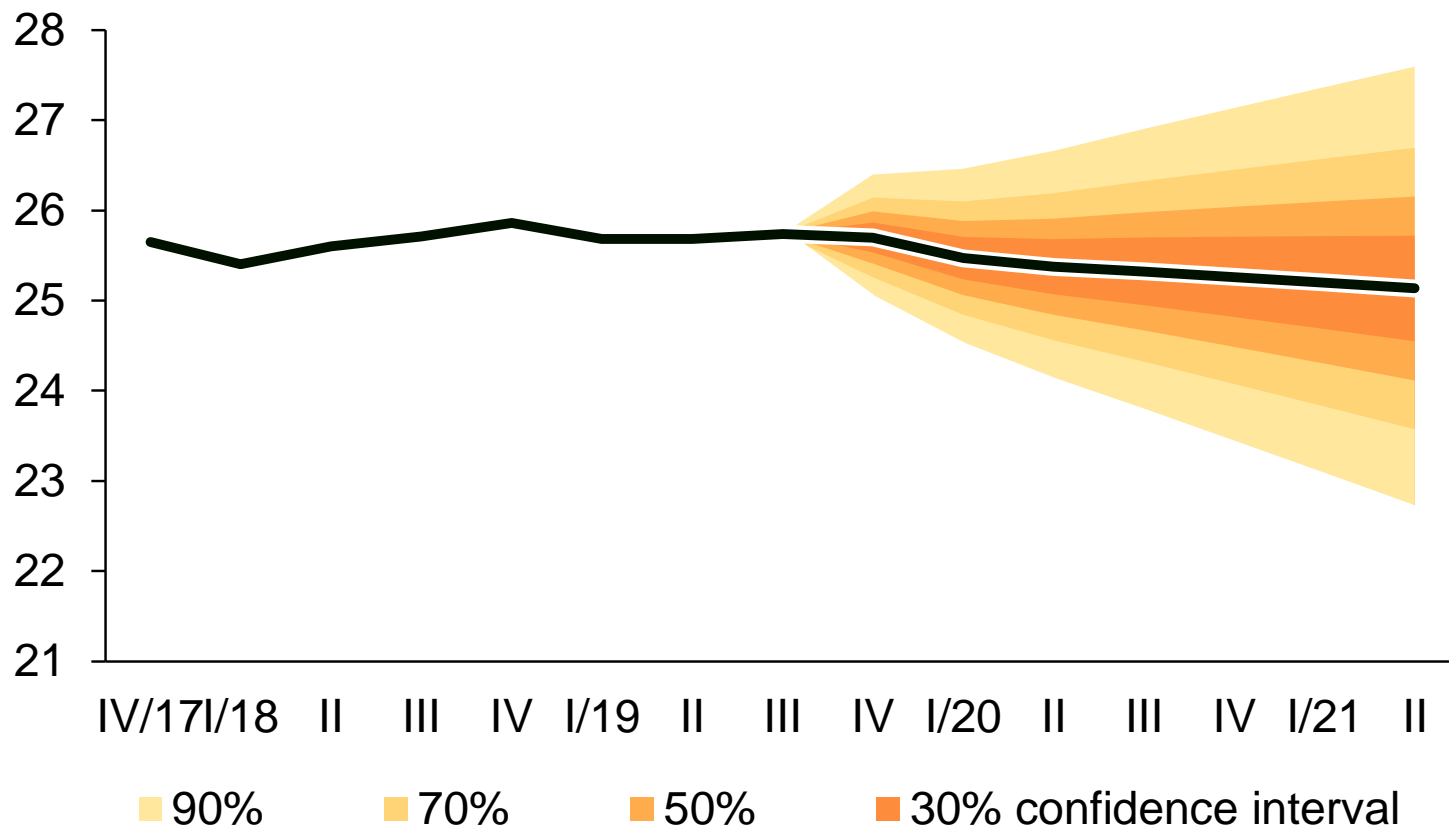


Note: Top 6 countries ranked by the monetary policy transparency index.

Source: Dincer, Eichengreen and Geraats (2019).

- According to the monetary policy transparency index, CNB ranked second among the most transparent central banks in 2015
- As of January 2020, CNB will further increase transparency by introducing attributed minutes

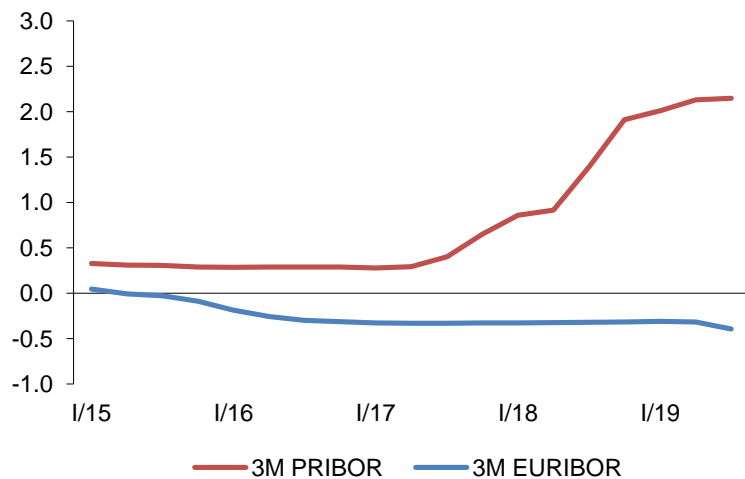
CZK/EUR exchange rate



Note: The confidence intervals of the CZK/EUR exchange rate forecast reflect the predictive power of past forecasts (with the exception of the exchange rate commitment period). They are symmetric and linearly widening.

Source: CNB Inflation Report, November 2019

Interest rates (in %)



Client interest rates (in %)

